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The Effect of the Earning Transparency on cost of capital common stock based on The Fama-French and Momentum Factors

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Abstract

The aim of this study was to evaluate the effect of the earning transparency on cost of capital common stock in companies listed on the Stock Exchange in Tehran. In this context, the variables of financial leverage, firm size, book to market ratio, market risk and momentum factor were used to assess the cost of capital common stock variable based on Fama–French Momentum Factors and earning transparency benchmark was used to measure earning transparency. In this study, a sample of 45 companies (16 industries) listed in the Tehran Stock Exchange were selected and research data has been extracted for the period 2002 to 2012. In this study, correlation method was used, and Statistical analysis of data was performed at 95% confidence level, and hypothesis testing was done by multivariate linear regression model. The results of this study showed that, of the variables studied, only the relationship between the three variables of financial leverage, company size and momentum with cost of capital common stock were significant statistically, while, there was no significant relationship statistically between earning transparency and book-to-market ratio and market risk with the cost of capital common stock.

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1. Introduction

Earning Transparency of the companies in recent years has become increasingly important, and nowadays financial reporting transparency is one of the most important financial issues , Francis et al. (2005) stated that the

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lack of Earning Transparency reported creates the information risk, as a result, investors will demand a higher risk premium, and consequently, the cost of capital common stock increases, and vice versa, with increasing more clear and unambiguous earnings reported and, the shareholder confidence has increased, and the expected rate of return for shareholders and consequently the cost of capital common stock has reduced. Thus, by reducing the quality of accounting information and earning, information risk of the company increases, and it increases the expected return to shareholders, and thus, the capital cost will rise.

Earnings quality can have consequences, such as increasing the efficiency of investment, the ability to predict future returns. Investors want to earn more earning, and reduce the risk of their investments. For this reason they are attempting to form portfolios, so they reduce risk by diversifying investments, or obtain maximum efficiency for a certain level of risk. The optimal portfolio selection needs assessment of both risk premium and portfolios return factors. Over the years, various models have been proposed to assess risk premium and portfolio return. The different models have been evaluated, and the results indicate that the factors considered in this model alone can't explain the relationship between risk premium and portfolio return. For this reason, the idea of combining these factors came together. For this reason, the idea of combining these factors was proposed. Therefore, in this study, the relationship between earnings transparency and cost of capital common stock has been investigated by Fama and French model and taking into account the momentum factor of the firms listed in the Tehran Stock Exchange. Therefore, the main question of the research is as follows:

Do earning transparency, momentum and Fama and French model variables affect the cost of capital common stock ?

2. Literature review

2.1. Earning transparency

Transparency of corporate information is a situation that information widely is accessible, relevant, reliable, comprehensive and timely. Bushman et al. (2004) and Nielsen et al (2009) argue that the user of the information at any time knows everything, and he can examine any subject based on clear information. Barth et al (2008) have defined earning transparency as change in earning and profitability (at the same time) with stock returns.

2.2. Measurement of earning transparency

One of the main challenges related to transparency in empirical studies is the measurement of transparency. In terms of quantifying, the transparency can be measured with an accuracy of information received conceptually. Accuracy of information is a function of the relevance and quality of information. Center of International Analysis and Research (CIFAR) has proposed an index of transparency, which this index is mean ninety scores of accounting and non-accounting items disclosed by a broad sample of companies in their annual reporting. The center has determined scores given to each property, and measures the amount of financial information transparency based on the score obtained (CIFAR, 1995). Berger et al. (2006), developed for measuring the measure the financial reporting transparency. The idea that they considered for measuring the earning transparency is based on the earning sustainability, because according to them, the volatility of stock returns is a ratio of a company's accounting transparency. This index in addition to the quality of financial reporting, measures financial transparency as well. Barth et al (2008), have used the relationship between earnings and stock returns to measure the earning transparency, so that, if the earning and the change in earnings and stock returns at the same time change (with regard to index R^2), earning is transparent.

2.3. Cost of capital common stock and earnings quality

Cost of capital common stock is related to expected returns conceptually. In other words, cost of capital common stock is defined as the minimum expected rate of return. If the expected return is lower than the cost of capital

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